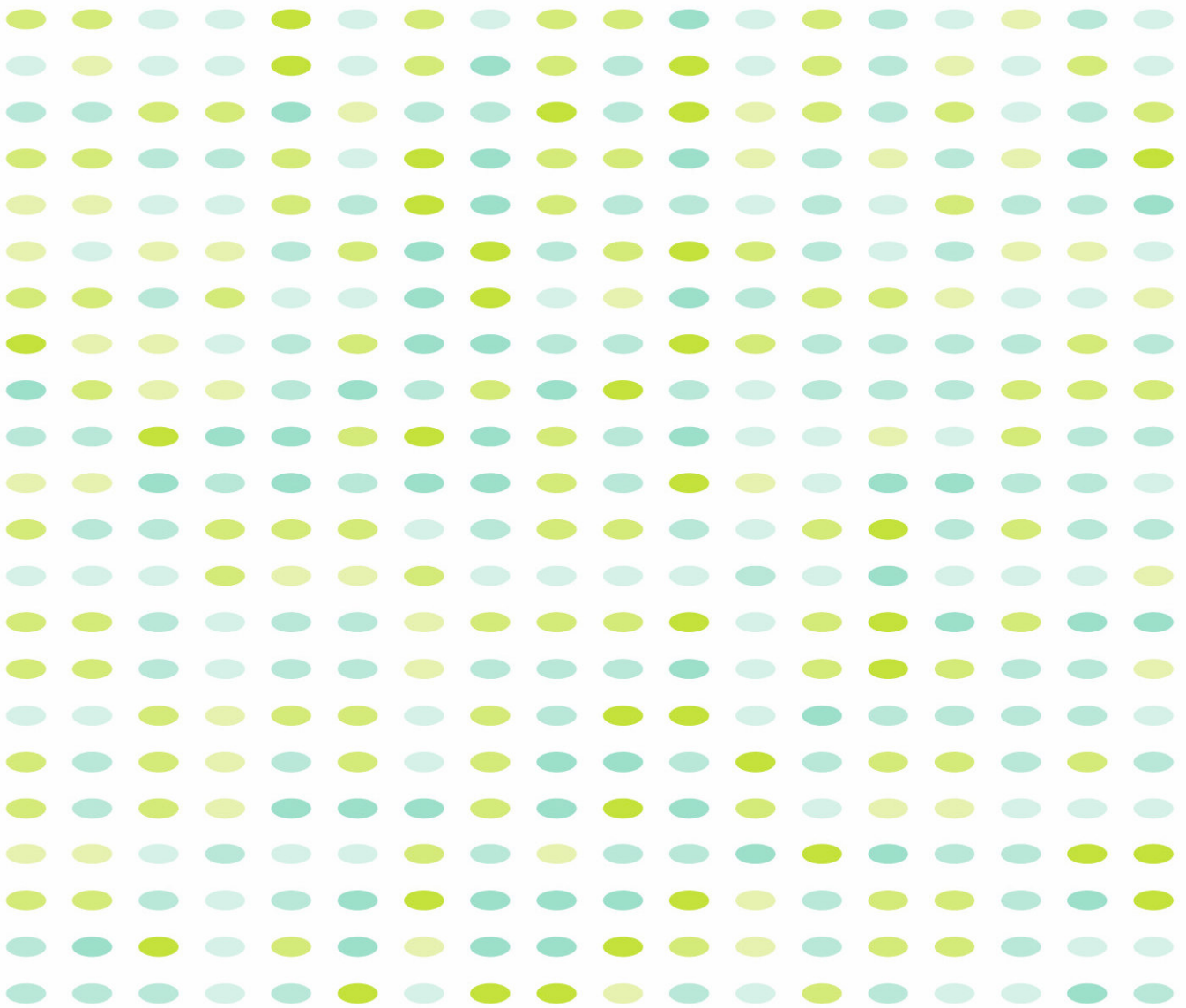


The SWAIN guide to Valuation



In conjunction with



Francis Clark

CORPORATE FINANCE

The SWAIN guide to Valuation

The South West Angel and Investor Network (SWAIN) connects private investors or “Business Angels” with companies looking for investments. SWAIN specializes in helping small and medium sized companies to find equity finance, and assists private investors in the South West to search for investment opportunities in businesses with growth potential.

The following guide has been produced to help you understand the nebulous and difficult topic of business valuation, and the intricately linked concept of deal structuring.

Business valuations

Valuing a business is a very imprecise science (in that there are rules but there are usually vague and rely upon many subjective judgements), and this is particularly true when considering raising equity. It is usually considered a vital part of the equity investment process as it is needed to assess the shareholding to be acquired by the equity provider.

However, most angel investments are made at an “interesting” time in a company’s development. This may be at the start of a new project, when the company has received a new order/made a new invention and needs to finance working capital or capital expenditure, etc. Agreeing a value of a company at this time can be extremely difficult, thereby making an imprecise science into a difficult (often impossible) and nebulous negotiation exercise. Therefore, whilst we discuss in this section an overview of valuation techniques, we return at the end to an alternative of how valuation discussions can be avoided or addressed in a more structured fashion.

Methodology

There are a number of ways to value a company, including (but not limited to):

- *Multiplying the underlying profits by a factor, known as the Price Earnings ratio (P/E).* This is one of the most common methodologies and is one we return to below.
- *Specific sector related valuation that may relate to turnover or net assets.* For instance, builders merchants can be priced

generally at approximately 2/3 of turnover. However, many of these rules are merely short cuts for a valuation based on underlying profits. Interestingly, as a general rule, the majority of businesses do not achieve a valuation above turnover, which seems to set a physiological limit on potential value.

- *Re-valuing all assets to present values* (mainly used for asset backed companies);
- *Predicting the surplus cash that will be produced by the business over the next few years and discounting this back to arrive at a present value for the company.* This a fairly complex exercise and, whilst widely used for larger plcs, is rarely fully used for smaller private companies; or
- *Deriving a value based on the potential dividend income arising.* This is regularly used for valuing minority shareholdings in larger companies that have a regular dividend pattern. Again, this rarely applies to companies looking for angel investment who have used their profits to fund future development and expansion.

By far the most common of these methods is the first, which requires an estimation of the maintainable future profits of a business and assessing the relevant P/E multiple.

Maintainable profits

Although the valuation is concerned with the future profit of the business, the easiest way to predict this is based on historic trading patterns. This is usually derived by taking the most recent profits and adjusting them for such items that were either one-off or will not

continue after the deal. Such items usually include:

- *adjustment of directors and shareholders costs to a commercial value (which can therefore increase or decrease stated profits);*
- *one-off substantial gains and losses made on the sale of company assets;*
- *interest paid on directors' loans;*
- *excessive (or no) rent paid on buildings owned by the vendors;*
- *adjustments for profits/losses made on sales to other group companies;*
- *the alteration of the tax charge to a notional charge at normal corporation tax rates; and*
- *other exceptional or non recurring items.*

The above requires a detailed review of the accounting information, and can entail an active discussion about, for instance, the commercial value of the directors.

PE Multiple

Once the underlying maintainable profit is estimated, this must then be applied to a profit multiple, the derivation of which is even more subjective than assessing the maintainable profit in the first place.

The textbook definition of deriving this multiple is to take a similar quoted companies PE ratio (listed in the FT or at www.londonstockexchange.com) and then discounting this amount for factors such as lack of size, track record, restriction on ability to sell shares easily, etc. Such discount factors can be between 25% and 75%, and assumes that a similar plc can be found.

Minority Discount

Finally, in terms of complications within this methodology comes the potential discount factor to be taken into account when valuing a minority shareholding in a company. Any shareholder with less than 50% of shares in a company has limited power (they cannot for instance appoint or fire directors) or statutory rights to receive information on that company's activities. These rights reduce even further for shareholdings of less than 25%. Whilst some of these restrictions can be bypassed by having a shareholders' agreement, it can still be relevant to discount the value of a minority shareholding and the range of discounts that can be applied range from 25% to 95%.

An alternative

Whilst all of the above can be overcome for larger companies with a solid track record, this does not often apply to companies seeking Angel investment. Alternatively, the owners of a larger company seeking Angel investment will want factors, such as a new venture or large one off order, taken into account in the valuation. Finally, what do you do if the company is currently loss making!

Therefore detailed discussions about valuation can be extremely difficult and discussion often get to "I think my company is worth £1m" v "I think your company is worth £250k" – not the most practical way to start a relationship.

We therefore strongly recommend that whilst consideration is given to the above, it is far better for both sides to actually discuss factors which they can at least debate openly rather than argue about opinions.

An equity provider will invest for many reasons, but one usual inclusion in any list is to make money, or to be more specific to obtain a good rate of return on their money. Venture Capitalists are very open about this, often quoting 30% to 40% as their required annual return, and we see no reasons why Angels cannot be similarly open – we also advise our clients seeking equity investment to be prepared for this figure (although this does obviously depend on the project).

It is easiest to explain how to calculate this return from an example. Let us take Mr A who is investing £150,000 in Company B in return for a 25% share. This company is expected to be worth some £2m in four year time. Therefore, Mr A shares in four years time would be worth £500,000. To grow the original £150,000 to £500,000 in four years time requires an interest rate (rate of return) of some 35.12% per annum, provable as follows:

- *Year one - £150,000 plus interest of 35.12% gives £202,680*
- *Year two - £202,680 plus interest of 35.12% gives £273,861*
- *Year three - £273,861 plus interest of 35.12% gives £370,041*
- *Year four - £370,041 plus interest of 35.12% gives £500,000*

Importantly, although the rate of return is 35.12% per annum, no annual payment is made to the investor.

More importantly, although the above does require an estimate of the value of the business, it requires this in four year's time, when the business should have built a track record. This allows the discussion on the relevant shareholding for the equity provider to concentrate on more solid factors than opinions of value now. The projections for the business should have been extensively discussed during the business assessment anyway.

This therefore leaves the discussion about the rate of return, which can be benchmarked against other commercial rates (such as the Venture Capital rates discussed above) and the value of the business in three/five years time, which is far easier to assess.

However, this more straight forward calculation can give rise to a shareholding for the equity provider that is higher than is acceptable to the company seeking funds. In the above example, if the company had required £500,000 to fund their expansion, and a rate of return of 35% (rounding for simplicity), this requires an initial shareholding of 83% - obviously unacceptable to the Company.

The solution to this requires a more in depth discussion about deal structuring.

Structuring deals

On the assumption that the investment by the Angel is made to maximise their return (and therefore the valuation exercise today is of relatively little concern), there are a number of different ways in which the return to the investor can be improved, whilst decreasing the initial shareholding taken:

- *Splitting the equity investors funding between repayable debt and equity;*
- *Having the equity part of the investment carry a fixed dividend rate or a dividend rate linked to profits*
- *Having the debt element of the investment carry a higher interest rate*
- *Having the debt element repaid as early as possible (subject to other funders consent of course)*
- *Charging a premium on the debt redemption (do for instance, for every £1 of initial, debt the repayment is £1.20) known as a premium on redemption.*
- *Structuring the deal in a tax efficient manner, dealt with further later in this guide.*

The above rely partly on the time value of money, which would tend to increase the return to the investors by paying more money to him earlier. For instance, as we saw above, an Angel who invest £150k into a company and gets £500k back in four years' time achieves a rate of return of 35%. If this £500k was achieved in three years' time, the rate of return becomes 49%, whilst a return of the same amount in year 5 would achieve a rate of 27%, purely through the effect of timing.

Debt/equity split

The splitting of the Angel funding between debt and equity is a classic way to meet the investors return requirements whilst also achieving a suitable shareholding for them acceptable to management. To review this effect, consider the following example whereby a Business Angel negotiates an investment of £250,000 into a business in return for a 20% equity stake. This would seem to indicate an overall value for the business of some £1.25m. However, if only £50,000 of this investment is in ordinary shares (with the balance of £200,000 in debt), the Business Angel can end up with 20% of the business at a net cost of only £50,000 (after the debt is redeemed by the business).

On the face of it this may seem an unfair valuation (and highlights that investment may not be as simple as first thought) but concentrating on this aspect of the process misses the main requirement for the Business Angel, which is the rate of return from the investment (known as the Internal Rate of Return or "IRR").

To evaluate the effect of the above, consider the difference between these scenarios:

1. Invest £250,000 for 20% of a business, which itself is sold for £1.5m three years after investment. The IRR from this investment would be just 6%— this is too low.
2. By translating £200,000 of the original investment into debt, which is redeemable over the three years, the IRR increases to 32%, making the deal potentially viable (assuming all other factors are right).

In any negotiations, the Business Angel's return must be the key focus. Any alterations to the deal may have an effect on this rate, and

this must be understood by the company and their advisers to properly negotiate any deal.

Comprehensive example

Often the Business Angel's equity investment will be part of a package or financial jigsaw. Equity is the most expensive form of finance and it is therefore sensible to use other forms of finance first. However, it is important to view the overall financial package involving equity to understand exactly where it fits and how the returns can be shared between all funders and the management of the Company,

For a full worked example of a financing deal involving debt and equity, take an MBO, where current profits are some £400,000 before taxation, and net assets are £800,000. A purchase price of some £1.5m has been agreed and the total finance needed is as follows:

| | |
|-----------------|--------------|
| | £'000 |
| Purchase Price | 1,500 |
| Costs | 100 |
| Working Capital | 250 |
| | <u>1,850</u> |

The financial package for the deal might therefore be as follows:

| | |
|--------------------------|---------------------|
| | £'000 |
| Management team input | 130 |
| Grants | 20 |
| Invoice Discounting | 350 |
| Plant and machinery loan | 250 |
| Mortgage | 300 |
| Unsecured loan | 200 |
| Overdraft | 100 |
| | <u>1,350</u> |
| Missing finance | 500 |
| | <u><u>1,850</u></u> |

The management team are happy with the consequences of raising equity and try to agree a package with a Business Angel.

The projections prepared by the management team show profits growing to a profitability of some £1m before taxation in five years time.

The package agreed with the Business Angel is as follows:

1. £50,000 into ordinary shares representing 27.5% of the company's shares, with rights to dividends equivalent to 30% of their share of profits after tax from year two;
2. £450,000 into debt carrying an interest rate of 8% and repayable in three instalments from year three.

The above factors can be shown in an abbreviated cashflow for the business and the business angel as follows:

| £'000 | Year | | | | | |
|----------------------------|--------------|------------|------------|------------|------------|--------------|
| | 0 | 1 | 2 | 3 | 4 | 5 |
| Business cashflow | | | | | | |
| Profits before tax | | 520 | 640 | 760 | 880 | 1,000 |
| Interest on borrowings | | (92) | (73) | (54) | (35) | (16) |
| Taxation | | (90) | (99) | (144) | (190) | (236) |
| Repayments of borrowings | | (150) | (150) | (150) | (150) | (150) |
| Angel debt interest | | (36) | (36) | (36) | (24) | (12) |
| Redeem Angel debt | | - | - | (150) | (150) | (150) |
| Ordinary dividend to Angel | | | (39) | (46) | (54) | (62) |
| Remaining cashflow | | <u>152</u> | <u>243</u> | <u>179</u> | <u>277</u> | <u>375</u> |
| Angel cashflow | | | | | | |
| Investment | (500) | | | | | |
| Debt interest | | 36 | 36 | 36 | 24 | 12 |
| Ordinary dividends | | - | 39 | 46 | 54 | 62 |
| Redeem Angel debt | | - | - | 150 | 150 | 150 |
| Exit valuation | | | | | | 1,375 |
| | <u>(500)</u> | <u>36</u> | <u>75</u> | <u>232</u> | <u>228</u> | <u>1,599</u> |
| Business Angel IRR | | | | | | 40.3% |

The above could be an acceptable rate of return for an Angel (again assuming a positive outcome on a plethora of other factors). However, you can now start to appreciate the number of factors that go into the above calculation.

Simply accepting the 27.5% of shares going to the Angel because it is close to their investment ratio (£500,000 equity input over a price of £1.5m) would be naive. It would also miss the fact that only £50,000 of the equity input is actually into ordinary shares.

Finally, the above emphasises how important the final sales value of the Business Angels shares are in the level of the return. In the above calculation, the value of the Angels investment has gone from £500,000 to £1.4m, based on the increase in profits of the business. Without this increase in valuation, the IRR decreases to 27%.

This therefore returns us to the topic of valuation – a valuation at day one of the above example could have been achieved due to the size of the figures. However, even in this case the valuation in five years time was much easier. The above example is at the very top end of Angel investment, but the techniques are applicable regardless of investment and company size. In more standard Angel investments, the valuation exercise today can be impossible and its bypassing by using the above is therefore critical.

Tax

Tax can significantly boost the return to the investor, mainly through EIS or EMI.

EIS

In brief EIS allows a Business Angel to invest up to £400,000 in qualifying unquoted companies trading in the UK. The Business Angel's Eligible shares must be held for at least 3 years from the issue date or commencement of trade if later. The Angel may not own more than 30% of the shares.

This can impact on structuring above, as EIS is given only on the ordinary shares acquired and not the value of the investment itself. Hence investments that are made up of a mixture of shares and loans etc are affected.

There are certain trades which are excluded from qualifying for EIS and these include:

- *dealing in land or property development*
- *banking, insurance or financial services*
- *leasing*
- *hotels*

An immediate deduction to income tax is given at the rate of 20% and Angels can carry back to the previous tax year up to a maximum of £50,000 as a deduction against income tax if they invest by 5 October.

Furthermore when the shares are sold after three years any capital gain on disposal of the shares is exempt from CGT.

It is also possible to defer any capital gains made on assets (where the disposal proceeds are reinvested under EIS) made one year before or three years after the disposal of the asset.

In addition where the investment does not work out and a capital loss is made on the shares the loss may be relieved against any income tax or capital gains tax payable.

EMI

Certain independent trading companies with gross assets not exceeding £30 million may grant share options then worth £100,000 to an eligible employee.

The total value of shares in respect of which unexercised qualifying options exist must not exceed £3m.

The company may be quoted or unquoted but must be an independent company trading or preparing to trade wholly or mainly in the UK. A company carrying on certain specified activities deemed to be lower risk activities does not qualify, such exclusions being similar to EIS.

Broadly, an employee is eligible if he is employed by the company for at least 25 hours per week or, if less, at least 75% of his total working time, and he controls no more than 30% of the company's ordinary share capital.

Companies are not required to obtain Revenue approval to schemes but must give notification to HMRC within 92 days after an option is granted.

Thus where Angels are taking an active role in the day-to-day running of the business they invest in it is possible that they might qualify for EMI options the chief benefit of which is that there is no charge to tax when the option is granted (provide the option to acquire the shares is not at less than their market values at that date) and there is no charge on exercise providing the option is exercised within 10 years.

Capital Gains Tax will be payable when the shares are sold, but Business Asset Taper Relief should be available and starts from the date on which the options are granted (not the date they are exercised).

Tax Summary

Both of the above can be used in specific circumstances to help improve the Angel's return (EIS), or structure the deal with management in a more efficient manner (EMI), which allows them to accept a better deal for the Angel. Both are however very complex and specific advice is needed in both areas.

Employee Shares

Finally on tax a brief warning about shares and employees.

Employee shares and Schedule 22 is a real tax minefield at present. It generally impacts on a management team, which may be investing at the same time as the Business Angel, or have their share rights altered when the Angel invest to contain more restrictions on them, for instance, having to sell their shares back to the company if they leave employment to prevent them leaving the company in the important early years post Angel investment.

HMRC can argue that these restrictions affect the price of the shares and that there is a difference between the "restricted" price and non-restricted price (i.e. the price once restrictions are lifted, perhaps 3 years post investment, depending on the legals). As such on the sale of the shares at a later date

HMRC could try and tax the gain made partly to capital gains tax (perhaps 10%) and partly to income tax (40%) based on the perceived difference between the "restricted" price and non-restricted price!

Furthermore, if the management team also invests at the same time as the Angel but at a different (often preferential rate), HMRC will argue that the management team is getting their shares at undervalue and the reason they are getting them at this price is because of them being employed by the company. HMRC can try to claim that the discount in price is a benefit on the employee and charge them tax on the benefit (and the Company national insurance) when they make their investment – even though they have not received any cash value at that time!

This new legislation was introduced to prevent employees from being rewarded in shares to circumvent the payment of income tax (for example of big city bonuses) but unfortunately impacts on most of the deals we look at.

Sounds complicated? It is and advice is essential on this matter as early as possible.

And finally

As a last note on valuation, the management team nearly always tend to overestimate the value of the business – this can be irrelevant to the deal and should not be allowed to become a distraction. By using the above concentration on rate of return, and exploiting the structuring techniques, a suitable deal can usually be found and reached without heated discussion on the nebulous concept of valuation.

Conclusion

Obviously good expert advice from experienced firms is critical in the above process. Details of such firms who are associate members of SWAIN can be found at

www.swain.org.uk/sponsors/sponsors.asp

Or if you would like to discuss any of the issues raised in this guidance note or would like a copy of our full guide to Equity/Venture Capital, please contact one of the Francis Clark's Corporate Finance team.

Francis Clark is one of the top Chartered Accountancy practises in the region with offices in Exeter, Newton Abbot, Plymouth, Salisbury, Taunton, Tavistock and Torquay.

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